IN THE

SUPREME COURT OF THE UNITED STATES

No. .....

PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1960.

No. .....

O. D. BRATTON and DOROTHY BRATTON, J. ROSS HOLCOMB, JR., FRANK A. CONKLING and EULA W. CONKLING, JAMES A. HOLCOMB and LOU H. HOLCOMB, and MRS. NOLAH D. HOLCOMB,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

To THE HONORABLE, THE CHIEF JUSTICE OF THE UNITED STATES AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Petitioners pray that a Writ of Certiorari issue to review the judgments of the United States Court of Appeals for the Sixth Circuit entered in the above cause.

OPINIONS BELOW.

The opinion of the Tax Court of the United States is reported at 31 T.C. 891 (1959) and a copy of which is attached hereto in the Appendix at pages A1-A17. The *per curiam* opinion of the United States Court of Appeals for the Sixth Circuit is reported at 283 F.2d 257. A copy of said opinion is appended to this Petition in the Appendix at pages A18-A20.

JURISDICTION.

The judgment of the Court of Appeals for the Sixth Circuit was rendered and entered on October 31, 1960, and a copy of said judgment is attached in the Appendix at page A21. An extension of time having been obtained, a Petition to Rehear was filed with said Court on December 1, 1960. The Petition to Rehear was denied without opinion on December 6, 1960. A copy of said order is attached hereto in the Appendix at page A22. Thereafter, the mandate of said Court issued, a copy of said mandate is attached in the Appendix at pages A23-A24.

It is by the judgment of the Court of Appeals for the Sixth Circuit embodied in this matter, together with the opinion rendered in support thereof, that petitioners are aggrieved and of which they now seek review in this Court.

Jurisdiction of this Court is envoked under Title 28, Section 1254 of the U. S. Code, reading in part as follows:

> "Cases in the Court of Appeals may be reviewed by the Supreme Court by the following methods:
>
> (1) By writ of certiorari granted upon the petition of any party to any civil or criminal case before or after rendition of judgment or decree;"

QUESTIONS PRESENTED.

The petitioners, cash basis taxpayers, were both creditors and stockholders in Hobac Veneer & Lumber Co., a Tennessee corporation, herein called "Hobac".

After the death of the principal manager of Hobac in 1951, the corporation began to lose money and a controversy arose among petitioners, as stockholders, in regard to the further operations of Hobac. This controversy was in large part due to the fact that Hobac was indebted to the petitioners, as creditors, in varying amounts. This indebtedness to petitioners represented commissions and salaries which had accumulated for a number of years. Hobac had not been able to pay the petitioners for their commissions and salaries when incurred since such indebtedness was subordinated to a loan obtained from the Union Planters National Bank of Memphis, Tennessee, herein called "Bank".

The questions presented are:

(1) Does a corporation have the right to satisfy its creditors by substituting the indebtedness of third parties to the corporation for the indebtedness of the corporation to its creditors?

(2) Does the consent by the creditors to the action of the corporation to such an arrangement constitute taxable income to the creditors as of the date of such consent?

(3) Can there be constructive receipt of income by petitioners, as creditors, when there is no unconditional title to such income as a matter of right?

STATUTES, FEDERAL RULES AND REGULATIONS INVOLVED.

The pertinent provisions of I.R.C. (1939), Section 22, formerly 26 U.S.C., Section 22, and Treasury Regulations, Regulation 118, Sec. 39.42-2, are set forth in the Appendix at pages A25-A26.

STATEMENT.

References prefixed by the letter "R" are to pages of the certified record of the Court of Appeals filed herein. References prefixed by the letters "App." are to the pages of the Appendix attached to this Petition.

The proceedings in these cases were consolidated for hearing in the Tax Court of the United States (R. 97) and were consolidated for review in the Court of Appeals for the Sixth Circuit. This Petition for Certiorari is filed herein on behalf of all petitioners. Original jurisdiction of the Tax Court is based on the provisions of I.R.C. (1954), Sec. 7442, 26 U.S.C., Sec. 7442. The petition for review of the decisions of the Tax Court was filed pursuant to the provisions of I.R.C. (1954), Sections 7482, 7483, 26 U.S.C., Sections 7462 and 7463.

Respondent, Commissioner of Internal Revenue, determined deficiencies in petitioners' income tax returns for the years 1952 and 1953. The alleged deficiencies resulted from petitioners' claims as creditors in Hobac being satisfied as to Hobac by the assumption of such indebtedness by third parties who were themselves indebted to Hobac (R. 5-12).

Hobac was engaged in the manufacture of lumbers and veneers (R. 99). Its assets for the year in question, 1952, consisted of a plant and mill located in Caruthers-

ville, Missouri; an inventory of logs, veneer, finished lumber, and timber lands (R. 99, App. A4). During the same period, its liabilities consisted of indebtedness to the Bank which was secured by a mortgage; accumulated salaries and commissions to the petitioners, and outside indebtedness of approximately $25,000.00 (R. 69, 100, App. A4). These unpaid commissions and salaries had accumulated over a period of years due to the fact that the funds of Hobac had been used to pay the indebtedness to the Bank. The "Term Loan Agreement" executed by Hobac with the Bank had expressly subordinated such future salaries or commissions to the Bank's indebtedness (R. 100).

Petitioners Conkling and Bratton, each owned a twenty-five (25%) per cent interest in the capital stock of Hobac. Petitioners, Nolah D. Holcomb, J. Ross Holcomb, Jr., and James A. Holcomb, succeeded equally to the twenty-five (25%) per cent interest of J. Ross Holcomb, Sr., deceased. The remaining twenty-five (25%) per cent interest in Hobac was owned by James T. Ahearn, who is not a party to these proceedings (R. 99).

J. Ross Holcomb, Sr., had actively managed the affairs of Hobac until his death in 1951. Thereafter, the business was managed by James T. Ahearn, whose affairs in 1952 would not permit him to continue to be charged with the responsibility of the operation of Hobac (R. 100, App. A4).

In 1951, when it appeared that Hobac would sustain an operating loss, the Holcomb heirs became desirous of realizing on their inherited holdings. Petitioners, Bratton and Conkling, were at that time undecided as to what should be done with Hobac (R. 101, App. A5). When a purchaser for all the stock of Hobac could not be found, considerable dispute arose between the stockholders in

regard to the manner in which Hobac could be sold or liquidated. Several plans were offered and rejected before the following transactions occurred which ultimately led to the dissolution of Hobac (R. 34-38, 40, 42-43, App. A5).

In September of 1952, Hobac sold its finished lumber for cash (R. 101). The best offer Hobac could obtain for its mill and related properties was an offer from Betz and Tipton, dba Betz-Tipton Veneer Co., herein called "Betz-Tipton", to buy such mill and related properties for long-term notes with no cash down payment (R. 36). Such offer was reduced to an Agreement on December 18, 1952, in which Agreement Betz-Tipton agreed to assume the indebtedness owed by Hobac to petitioners, as creditors, with said indebtedness to be payable from the proceeds of the long-term notes issued by Betz-Tipton to Hobac. Petitioners, as creditors, accepted such Agreement and agreed to look to Betz-Tipton for payment of their indebtedness and released Hobac from any further claims arising out of such indebtedness (R. 74-77, App. A6). The remaining inventory was then sold by Hobac to Betz-Tipton for a demand note which was also made a part of the Agreement of December 18, 1952 (R. 77-79).

It is important to note that these promissory notes were stated to be negotiable in the opinion of the Tax Court (R. 112, App. A16). This is in direct conflict with the terms of the notes which are set out in the Findings of Fact of the Tax Court which show that such notes were not negotiable, not having been payable "to order of" or "to bearer" (R. 104-105, App. A9).

The Union Planters National Bank agreed to act as pledgee of the notes given by Betz-Tipton in an agreement executed on December 20, 1952, between the Bank, Hobac and petitioners, as creditors of Hobac. The terms of the

Pledge Agreement provided for payment of Hobac's indebtedness to Bank from the promissory notes and thereafter the petitioners, as creditors, were to receive payments for their claims (R. 79-84, App. A9). On the same date, the written consent of the Bank to proceedings necessary to liquidate Hobac was obtained. This consent was necessary under the terms of the Term Loan Agreement executed by the Bank and Hobac (R. 84-89, App. A4).

Promptly following the Bank's execution of the "Consent to Liquidation", a formal joint meeting of the Stockholders and Directors was held. The minutes of this meeting show that the sales to Betz-Tipton had been approved and that Hobac had been released and discharged from further liability to its creditors. At this meeting for the first time a resolution was proposed and adopted authorizing liquidation of Hobac and distribution of Hobac's timber lands to the stockholders of Hobac for their capital interests (R. 89-94). The timber lands were then distributed in 1952 to the stockholders, as a partial distribution, for their capital interests; and thereafter, in 1953, the remaining assets were distributed and the Charter of Incorporation was surrendered on October 1, 1953 (R. 106, App. A10).

The amounts realized from the sale of timber lands by petitioners were included in their 1952 returns as amounts received as a partial distribution on their stock, and the difference between these amounts and the cost of their stock was reported as gains from the sale of capital assets. The sums distributed from year to year to petitioners, Bratton and Conkling, from collections on deferred purchase money notes have been treated as ordinary income in the year in which received and this approach is now being urged upon the Court by all petitioners (R. 106-107, App. A11).

The Tax Court concluded in its decision that petitioners received both the timber lands and the Betz-Tipton notes during 1952 by way of distributions in liquidation. To the extent of the petitioners' claims as creditors, these distributions would then represent ordinary income with the remainder to be applied against petitioners' capital interests (R. 113-114, App A17). The Court of Appeals in its *per curiam* opinion affirmed the decisions of the Tax Court on the basis of such conclusion (R. 130-131, App. A19).

REASONS FOR GRANTING THE WRIT.

The Court of Appeals for the Sixth Circuit in affirming, *per curiam*, the opinion of the Tax Court held that petitioners constructively received income in the year 1952 (R. 130-131, App. A20). By so doing, the Court of Appeals has extended the doctrine of constructive receipt of income far beyond the boundaries set forth in the decisions of other Circuits of the Court of Appeals and beyond the limitations contained in the Regulations issued by the Treasury Department. See Reg. 118, Sec. 39.42 (1939) (App. A26).

In its opinion, the Court of Appeals summarized the contentions of the parties and the holding of the Tax Court as follows:

> "The real dispute, between the parties relates to the manner in which the notes should be treated for tax purposes. Taxpayers claim that the notes should not be considered as a distribution in cash and that they should be taxed only on the actual installments paid on the notes as and when received by them from the bank. Taxpayers insist that the notes were never delivered to them and that they have neither title to or possession of the notes.

The Commissioner on the other hand maintains that the notes should be taxed at their full face value in 1952, at the time when they were transferred to the bank.

The Tax Court determined that the transfer of the notes to the bank was in reality for the benefit of the taxpayers and that the bank in collecting the installment payments and distributing them to taxpayers was acting as their agent. The Tax Court further held that the notes should be taxed at their full face value at the time of the assignment to the bank since there was no proof that their fair value was any less, citing *Loyer* v. *Commissioner*, 199 F.2d 452 (C.A. 6, 1952)."

Bratton et al. v. *Commissioner*, *supra*, 283 F.2d at p. 258.

(R. 130; App. A19.)

The conclusion of the Court that acts done by Hobac which might benefit petitioners, in their capacity as creditors of Hobac, is an unusual basis for imputing constructive receipt of income to a taxpayer. The undisputed facts were that Hobac owned long-term promissory notes which carried no terms of negotiability such as "to order of" or "to bearer" (R. 112, App. A9). These notes were never conveyed, transferred or assigned to petitioners, either in their capacity as creditors or stockholders of Hobac. They were placed in an escrow account with the Bank under a Pledge Agreement whereby the proceeds from the notes were to be held by the Bank until such time as the Bank's indebtedness had been paid in full and thereafter the proceeds were to be distributed to petitioners for their claims as creditors of Hobac (R. 79-84, 104, App. A9).

No one of the petitioners had any right in any capacity to demand possession of the notes from the Bank. Under the terms of the Pledge Agreement, the Bank had

the sole right to bring any action on the notes. The indebtedness due petitioners was expressly subordinated to the Bank, as pledgee, "until those indebtednesses shall have been paid in full" (R. 80, 105, App. A9). The trust deed which secured payment of the pledged notes was subject to a pre-existing mortgage in favor of the Bank (R. 81).

With these undisputed facts, it became a problem for the Tax Court to determine in what manner petitioners, as creditors had received income in the year 1952. The respondent presented several theories to the Tax Court. The original position of the respondent, which is set forth in its ninety-day letters to petitioners, was virtually abandoned in the Tax Court. At the conclusion of the hearing in that case, four alternative theories were made part of the respondent's answer (R. 20-24). The theory which was accepted by the Tax Court and affirmed by the Court of Appeals is as follows:

> "(b) Respondent alleges in the alternative that if the Court should determine that the petitioner pursuant to the liquidation of the corporation received both the interest in the timber lands and the interest in the collateral pledge agreement involving the Betz-Tipton notes in the year 1952, then the petitioner received in the year 1952, payment in full of the compensation owed by the corporation, taxable as ordinary income, and liquidating dividends entitled to capital gains treatment. Since respondent in his notice of deficiency determined that petitioner received full payment of the compensation owed him by the corporation in 1952, and received part of the liquidating dividends in 1952, and the balance in 1953, a finding by the Court that both full payment of the compensation and receipt of liquidating dividends occurred in 1952, will result in additional income and an increased deficiency for the year 1952."
>
> (R. 22, 108, App. A12.)

Since it was not denied that petitioners never received the promissory notes payable to Hobac and in no way owned them, the Tax Court concluded that the petitioners had constructively received the promissory notes during the year 1952 (R. 113, App. A16). This finding is in direct conflict with the Regulations propounded by the Treasury Department and which have been in effect since 1918. On familiar principles, these Treasury regulations of over forty years' standing possess the force of law. *Boehm* v. *Commissioner*, 326 U.S. 281 (1945). Such regulations require that a taxpayer have, in effect, the income set aside for him and payable at his will, without substantial limitation, before such income can be held to be constructively received by him (App. A26).

What the Court meant when it stated that the Bank was acting for the benefit of petitioners is unknown, but certainly such reason does not make the Bank the agent of petitioners. What control could the petitioners, as principals, exercise over the Bank as their agent as required by Tennessee law? *National Cash Register Co.* v. *Leach*, 3 Tenn. App. 411 (1926). By what contract or course of action did a contract arise between petitioners, as creditors, and the Bank which would create a principal-agent relationship. *Prater* v. *Fidelity Trust Co.*, 161 Tenn. 626, 34 S.W.2d 205 (1930). None of the relationships required by the law of Tennessee existed between the Bank and petitioners which would form a principal-agent relationship.

This Court has held in *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950), that Congress has determined that different tax consequences shall flow from different methods by which the stockholder of a closely held corporation may dispose of its corporate property. It follows that Hobac may satisfy the claims of its creditors,

even if they be shareholders, in such manner as would be acceptable to the interested parties, even if this results in the creditors accepting postponement of receipt of the payments to be applied on the indebtedness.

A creditor may even voluntarily relinquish amounts due by a corporation without incurring a tax liability. See *John Harvey Kellogg* v. *Commissioner*, 2 T.C. 1126 (1943).

In *McLaughlin* v. *Commissioner*, 113 F.2d 611 (7th Cir., 1940), the Court of Appeals for the Seventh Circuit was faced with a similar situation. There notes given for the purchase price of corporate stocks and the stock were deposited with an escrow agent by the seller and the purchaser. The escrow agent was authorized to collect the notes and deliver the stock to the makers of the notes. The first of the purchase money notes was paid in full in 1931, the year in which the sale took place. The Commissioner treated all the remaining notes which were due in subsequent years as income to taxpayer and his associates in 1931 and asserted a deficiency.

The Court of Appeals ruled in favor of the taxpayer, stating that the decisions which have held that the receipt of notes constitutes a receipt of income rests upon the factual conclusion that the notes are for all practical purposes equivalent to cash. The Court said that in no practical sense can a promissory note be said to have cash equivalence to the payee if the payee had no power of sale or, at least, the power to pledge the note as security for a loan. The Court pointed out that the payee not only did not have actual control or custody of the notes, but under the escrow agreement he was without legal power to obtain possession of the notes or in any manner utilize them for business purposes.

It seems that every contention advanced by the Commissioner and every reason given by the lower courts were urged upon the Court of Appeals in the McLaughlin case. That Court answered each and every of the Commissioner's contentions in favor of the taxpayer. These petitioners urged the holding in the McLaughlin case upon the lower courts. It is safe to assume that, not being able to distinguish the McLaughlin case, the Court of Appeals and the Tax Court simply ignored it.

It has been held that money paid in escrow pending discharge of a tax lien does not constitute constructive receipt of income. *Sloane* v. *Commissioner*, 188 F.2d 254 (6th Cir., 1951). Nor has there been constructive receipt in the year money was deposited in Court as compensation for property taken by condemnation. *Nitterhouse* v. *United States*, 207 F.2d 618 (3rd Cir., 1953), cert. den. 347 U.S. 943. Relying on the Regulations, as its authority, the Court in *Commissioner* v. *Carpenter*, 219 F.2d 635 (5th Cir., 1955), held that it is fundamental in income taxation that before a cash basis taxpayer may be charged with the receipt of income, the taxpayer must receive cash or property unqualifiedly subject to his demands.

Associate Justice Stewart, while a member of the Court of Appeals for the Sixth Circuit, recognized the right of taxpayers to so arrange their affairs that where there are two methods of procedure, one of which may result in a greater tax liability than the other, the taxpayer may choose the method which would result in the lower tax liability. The language of Justice Stewart is as follows:

> "It is true that the syndicate members could have achieved their objective, yet completely avoided the tax liability here imposed, simply by their purchase of the two hundred shares owned by the minority

shareholders, followed by Buckeye's redemption of all Mrs. Derby's stock. We can assume that if the transaction had been cast in that form neither petitioners nor Mrs. Derby would have been charged with the receipt of ordinary income. Cf. Zenz v. Quinlivan, 6 Cir., 1954, 213 F.2d 914."

Woodworth v. *Commissioner*, 218 F.2d 719 at 724 (6th Cir., 1955).

As if to bolster the basis of the opinion of the Tax Court, the Court of Appeals held that in any event the decisions of the Tax Court could be justified on the grounds of novation; that is, the substitution of a new debtor in place of an old one. The Court then cited Tennessee cases which purportedly held that such novation constituted payment and discharge of the indebtedness.

These cases, *Southworth* v. *Thompson*, 57 Tenn. 10 (1872), and *Union Bank of Tennessee* v. *Smiser*, 33 Tenn. 501 (1853), do give support to the theory of novation as being a method of discharging indebtedness but neither case gives any indication that the acceptance of a new debtor in place of an old debtor constitutes income within the meaning of I.R.C. (1939), Section 22. It is respectfully submitted that in no event could such cases be cited as authority that the acceptance of a new debtor in place of an old debtor constituted income within the meaning of the above code section.

The petitioners contend that such a novation did in fact exist to the extent that one debtor was substituted for another debtor, but that such substitution did not constitute receipt of taxable income to petitioners.

The decision of the Court of Appeals in affirming the Tax Court opinion which relied on the principle espoused in *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945), that substance rather than form controls the tax effect of

transactions, and which has been lately amplified in *Knetsch* v. *Commissioner*, ... U.S. ....., 5 L. Ed. 128, indicated that it felt there was nothing of substance to the transactions by which Hobac disposed of petitioners' claims as creditors (R. 109, 130-131; App. A19).

When it is remembered that the mill and related properties had no such cash value, but the best offer received by Hobac for such property was the receipt of long-term notes, bearing a small rate of interest and which were not negotiable as shown by the Findings of Fact of the Tax Court, would not any individual see why readily salable timberlands were used to satisfy the capital interests of petitioners as stockholders? Under the terms of the Collateral Loan Agreement executed by Hobac with the Bank, and petitioners, as creditors of Hobac, the funds received from these notes were not to be applied toward payment of petitioners' claims as creditors until such time as the Bank had been paid in full. This is why such notes were required to be held in escrow and why petitioners were not able to exercise control or ownership over such notes.

In its recent opinion in *Knetsch* v. *Commissioner*, *supra*, this Court stated that the trial court's findings "that there was no commercial economic substance to the * * * transactions" and "no economic gain could be achieved from the purchase of these bonds without regard to the tax consequences * * * " were conclusions of law which were reviewable by this Court. Under such ruling, the implications by the Tax Court and Court of Appeals in the instant cases that the transactions between Hobac, Betz-Tipton, and petitioners, as creditors, had no economic consequences and were of no substance are thus matters which are properly reviewable by this Court.

The decision of the Court of Appeals affirming the decision of the Tax Court has so far extended the doctrine

of constructive receipt of income that serious questions will in the future arise as to the receipt of income by other taxpayers. The Regulations propounded by the Treasury Department and which have been in effect over forty years have been disregarded in the formulation of these decisions in the lower courts and this Court's power of supervision should be used to review the questions presented herein.

In addition, the Court of Appeals for the Sixth Circuit has drawn strikingly different conclusions of law in these cases than did the Court of Appeals for the Seventh Circuit in the case of *McLaughlin* v. *Commissioner, supra.* The only means of settling these questions which are of importance, not only to petitioners but to all taxpayers, is for this Court to grant the relief prayed for herein.

PRAYER.

Petitioners, therefore, respectfully pray that a writ of certiorari issue out of and under the seal of this Court, directed to the United States Court of Appeals for the Sixth Circuit, commanding that Court to certify and send to this Court for its review and determination on a day certain to be therein named a full and complete transcript of the record and proceedings in the case entitled on its docket: *O. D. Bratton et al., Petitioners,* v. *Commissioner of Internal Revenue, Respondent,* No. 14,062, to the end that said case may be reviewed and determined by this Court, as provided by Section 1254 of Title 28 of the United States Code and the applicable rules promulgated by this Court governing applications for certiorari in civil cases, and that the judgment of the Court of Appeals in these consolidated proceedings be reversed by decree of this Honorable Court adjudicating that respondent is entitled to no recovery against any of these petitioners and reliev-

ing petitioners of all liability for costs, and that petitioners have such other and further relief in the premises as to this Honorable Court may seem right and proper.

WALTER P. ARMSTRONG, JR.,

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Attorneys for Petitioners.

ARMSTRONG McCADDEN ALLEN BRADEN & GOODMAN,
Of Counsel.

CERTIFICATE OF SERVICE.

I, WALTER P. ARMSTRONG, JR., a member of the Bar of the Supreme Court of the United States of America, certify, in conformity with Rule 23 of that Court, that a copy of the foregoing petition was served upon Respondent, Commissioner of Internal Revenue, pursuant to Rule 33 of that Court, by mailing, by regular U. S. mail, postage prepaid, to the Office of the Attorney General of the United States, counsel of record of the Respondent, this ..... day of February, 1961.

WALTER P. ARMSTRONG, JR.,
Attorney for Petitioners.

APPENDIX A.

31 T. C. No. 87

TAX COURT OF THE UNITED STATES

O. D. BRATTON and DOROTHY BRATTON et al.,[1] Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket Nos. 60092, 60093, 60105, 60112, 60113.
Filed January 29, 1959.

The stockholders of a close corporation, indebted to them for compensation of $166,000, decided to liquidate. In December 1952, certain assets were sold for the vendees' notes in the amount of $205,000, plus a purported assumption of the corporation's indebtedness to its stockholders, it being provided that all payments on the notes were to be credited on that indebtedness. The corporation pledged the notes with a bank to secure its stockholder-indebtedness, the bank to collect the proceeds thereon for the stockholders' account, with the right to defer payment of any amount collected in excess of $18,500 a year. The corporation's timberlands valued at $290,000 were then distributed to its stockholders. In 1953 the corporate charter was surrendered. Petitioners, as stockholders, treated the timberlands as received in liquidation of their stock; and, to the extent of the compensation owed them, treated the amounts received under the pledge agreement as ordinary income in the year of actual receipt.

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1. Proceedings of the following petitioners are consolidated herewith: J. Ross Holcomb, Jr., Docket No. 60093; Frank A. Conkling and Eula W. Conkling, Docket No. 60105; James A. Holcomb and Lou H. Holcomb, Docket No. 60112; Nola D. Holcomb, Docket No. 60113.

Held, the net effect of these various transactions was a complete liquidation of the corporation as well as a satisfaction of its indebtedness to its stockholders in 1952. To the extent of the corporation's indebtedness, the value of the assets received by its stockholders represented ordinary income, anything in excess thereof represented payment for their stock.

John J. Doggett, Jr., Esq., Hubert A. McBride, Esq., and *Lowell W. Taylor, Esq.*, for the petitioners.

Homer F. Benson, Esq., for the respondent.

TIETJENS, *Judge*: These consolidated proceedings involve deficiencies in income tax and additions thereto in the amounts and for the years as set forth below:

Docket No.	Year	Petitioner	Deficiency	Addition to Tax Sec. 294 (d) (2)
60092	1952	O. D. and Dorothy Bratton	$14,015.39	$ —
	1953	O. D. and Dorothy Bratton	4,856.90	508.98
60093	1952	J. Ross Holcomb, Jr.	8,054.09	—
	1953	J. Ross Holcomb, Jr.	207.25	—
60105	1952	Frank A. and Eula W. Conkling	17,913.44	—
	1953	Frank A. and Eula W. Conkling	4,400.22	—
60112	1952	James A. and Lou H. Holcomb	4,229.16	—
	1953	James A. and Lou H. Holcomb	424.88	—
60113	1952	Nola D. Holcomb	4,168.91	265.49
	1953	Nola D. Holcomb	104.18	—

By amended answer respondent, pleading in the alternative, claimed increased deficiencies in each of the above proceedings and an increased addition to tax under section 294(d)(2) in Docket No. 60113 for 1952; and further, by way of a second alternative, claimed increased deficiencies in each of the above proceedings and an increased addition to tax under section 294(d)(2) in Docket No. 60092 for 1953.

The issue for decision is the proper tax consequences of certain transactions undertaken in carrying out the

liquidation of a corporation, primarily being whether the fair market value of certain purchase money notes taken by the corporation for the sale of assets and transferred to a bank as pledges in satisfaction of indebtedness owed by the corporation to its stockholders, is income to the stockholder-creditors in the year the sale was consummated.

FINDINGS OF FACT.

O. D. and Dorothy Bratton, husband and wife, resided in Memphis, Tennessee during the taxable years 1952 and 1953, and filed joint Federal income tax returns for those years with the director of internal revenue for the district of Tennessee.

J. Ross Holcomb, Jr., resided in Memphis, Tennessee, during the taxable years 1952 and 1953, and filed individual Federal income tax returns for those years with the director of internal revenue for the district of Tennessee.

Frank A. and Eula W. Conkling, husband and wife, resided in Memphis, Tennessee during the taxable years 1952 and 1953, and filed joint Federal income tax returns for those years with the director of internal revenue for the district of Tennessee.

James A. and Lou H. Holcomb, husband and wife, resided in Chattanooga, Tennessee during the taxable years 1952 and 1953, and filed joint Federal tax returns for those years with the director of internal revenue for the district of Tennessee.

Nola D. Holcomb resided in Memphis, Tennessee during the taxable years 1952 and 1953, and filed individual Federal tax returns for those years with the director of internal revenue for the district of Tennessee.

Unless otherwise noted, each of the above individuals will hereinafter be referred to as the petitioners.

Hobac Veneer and Lumber Company (hereinafter referred to as Hobac), a Tennessee corporation, was engaged in the manufacture and sale of lumber and veneers. It maintained a plant and mill located at Caruthersville, Missouri, and owned certain timber lands. All its capital stock was owned equally by O. D. Bratton, J. Ross Holcomb, Sr., Frank A. Conkling, and James Ahern. J. Ross Holcomb, Sr., died prior to the years in issue, and his one-quarter interest in the business passed to his widow, Nola D. Holcomb, and his sons J. Ross Holcomb, Jr., and James A. Holcomb, petitioners herein.

Prior to the years in issue, Hobac secured from the Union Planters National Bank & Trust Company a loan of $200,000 which was secured by a mortgage upon its mill and timberlands. By December 1952, Hobac had reduced that indebtedness to $47,681.40.

Hobac, as of December 20, 1952, was indebted to its stockholders for commissions and salaries in the following amounts:

Stockholder	Amount
J. Ross Holcomb, Sr., Estate	$38,691.10
O. D. Bratton	54,993.06
Frank A. Conkling	55,380.08
James T. Ahern	17,317.34

Each of those indebtednesses had been subordinated to the aforementioned loan.

Until his death, J. Ross Holcomb, Sr., had actively managed the affairs of Hobac. Thereafter, until 1952, the business was managed by James Ahern. At that time his

own affairs prevented him from devoting sufficient time to his duties.

During 1951, Hobac lost money, and the Holcomb heirs became desirous of liquidating the business. On the other hand, Bratton and Conkling were undecided as to what should be done with the corporation. Beginning in the summer of 1952, a series of conferences were held in an attempt to devise a means of liquidating the stockholders' interest in the most advantageous manner. Various proposals were submitted and rejected. As the largest creditor, Conkling was opposed to any plan which failed to equalize the debt due him with that of the other stockholder-creditors, or which might result in a substantial tax to the corporation and a further tax to him. Unsuccessful attempts were made to find a purchaser for all the corporation's outstanding stock. However, a purchaser was secured for the company's lumber inventory, and it was sold on September 13, 1952, by Hobac for $50,000.

Further negotiations took place as a result of which it was suggested that the mill be sold to E. L. Betz and Joseph Tipton on a long-term credit basis. Conkling was opposed to any such sale. To obtain his consent, the other stockholder-creditors agreed to an equalization of the indebtednesses then owed them by Hobac. After reciting that a decision to liquidate the company had been reached, pursuant to which Hobac had disposed of its lumber inventory and had agreed to sell its mill and related properties to Betz and Tipton in exchange for their notes, a mortgage upon the property and a purported pledge of collateral security with the Union Planters National Bank, and further reciting that as part of that plan Hobac's timberlands were to be distributed to its shareholders subject to a mortgage thereon in the amount of $47,681.40 in exchange for their stock, and that they had agreed to sell

those lands to the Anderson-Tully Company for $290,000 less the mortgage indebtedness, the stockholders agreed that Anderson-Tully should pay the net proceeds of that sale to the Union Planters National Bank as their trustee in the following manner:

O. D. Bratton	$ 72,297.31	
Frank A. Conkling	72,684.33	
Nola D. Holcomb	18,665.12	
J. Ross Holcomb, Jr.	18,665.12	
James A. Holcomb	18,665.12	
James T. Ahern	34,621.60	
Expenses of Sale	6,720.00	
Total		$242,318.60

With the consent of its stockholders, Hobac, on December 18, 1952, sold its mill and related properties to Betz and Tipton in consideration for their long-term notes in the amount of $150,000, and their agreement by virtue of which they purported to assume Hobac's indebtedness to its stockholders in the amount of $166,381.58. To effectuate that sale, the notes were delivered, the property deeded to Betz and Tipton, and an agreement executed which, after reciting Hobac's indebtedness to its stockholders, provided in part as follows:

> As a further consideration for the sale by Hobac to Betz and Tipton of the mill, lands and other physical properties and assets at the prices and upon the terms stated in the deeds, bill of sale and other instruments, Betz and Tipton hereby assume and agree to pay all the foregoing indebtednesses, with interest at the rate of three percent (3%) per annum, upon the express condition, however, that all amounts realized from the collection of the deferred purchase money notes and demand note given by Betz and Tipton as evidence of the deferred purchase price of the mill, lands, phys-

ical assets, etc., and all amounts realized from any foreclosure and sale under the trust deed given by Tipton and Betz to secure said deferred purchase money notes and demand note be applied to the payment and satisfaction of the foregoing indebtednesses, except such expenses as may necessarily be incurred in the handling and collection of said deferred purchase money and demand notes. And Betz and Tipton agree that the Union Planters National Bank, which will hold the deferred purchase money notes and demand note as collateral security, may pay from time to time, as requested by the above named creditors, any amounts it may have on hand representing payments of said deferred purchase money notes and demand note to said creditors, all said payments to be applied and credited on the deferred purchase money notes and demand note.

Appended to that document was the following agreement executed by Hobac's stockholder-creditors:

We, the undersigned, hereby consent to the foregoing agreement, and agree to and do hereby release Hobac Veneer and Lumber Company, Inc., from any additional or further liability to us upon the aforesaid indebtednesses, and agree to look to the collateral security hypothecated with Union Planters National Bank and to Ernest L. Betz and Joseph R. Tipton for the satisfaction and payment of said indebtednesses.

On December 20, 1952, Hobac sold its log and veneer inventories, along with other assets, to Betz and Tipton in return for their demand note in the amount of $55,729.79. Also on that day, a special meeting of its stockholders and directors was held, and it was resolved that the sale of its mill, mill site, equipment, inventories and other assets, and the purported assumption of its indebtednesses to its stockholders by Betz and Tipton be approved and ratified, and further that the notes executed by Betz and Tipton to

gether with the deed of trust securing them were to be pledged as collateral security for payment of Hobac's indebtednesses to its stockholders. Finally, it was resolved that:

> BE IT FURTHER RESOLVED that the Company be liquidated and dissolved, and that all of the timber lands owned by the Company be conveyed to the stockholders of record in partial liquidation of their capital stock in the Company, and that the Officers and Directors proceed forthwith to complete the liquidation as speedily as possible by the sale and realization on all other assets of the Company and the payment of all the Company's liabilities not assumed by Betz-Tipton Veneer Company.
>
> BE IT FURTHER RESOLVED that the attorney for the Company give notice to the Commissioner of Internal Revenue of the action this day taken as required by the Internal Revenue Laws.

Under date of December 20, 1952, Hobac distributed its timberlands to its stockholders. They immediately conveyed those lands to the Anderson-Tully Lumber Company for $290,000. Anderson-Tully thereupon issued one check to the Union Planters National Bank in the amount of $47,681.40 extinguishing the balance owed by Hobac on its loan. It issued a second check, in the amount of $242,318.60, to Hobac's stockholders which was deposited with Union Planters as trustee in accordance with the equalization agreement.

Further, on December 20, 1952, Hobac, purporting to act as pledgor, executed an agreement with the Union Planters National Bank, whereby it purported to pledge the Betz-Tipton notes in the face amount of $205,729.79 with Union Planters to secure its indebtedness to its stockholder-creditors. The notes so pledged were described as follows:

36 promissory notes Nos. 1 to 36 inclusive, in amount of $1600.00 each, dated September 24, 1952, bearing interest at rate of 6% from maturity, said notes being payable monthly commencing April 1, 1953, to Hobac Veneer & Lumber Co., Inc., at Union Planters National Bank, Memphis, Tenn.;

57 promissory notes Nos. 37 to 93 inclusive, in amount of $1600.00 each, dated September 24, 1952, bearing interest at rate of 3% per annum from September 24, 1955, said notes being payable monthly commencing April 1, 1956, to Hobac Veneer & Lumber Co., Inc., at Union Planters National Bank, Memphis, Tenn.;

1 promissory note No. 94 in amount of $1200.00 dated September 24, 1952, bearing interest at rate of 3% per annum from September 24, 1955, said note being payable January 1, 1961, to Hobac Veneer & Lumber Co., Inc., at Union Planters National Bank, Memphis, Tenn.;

1 demand note for $55,729.79.
and

Trust deed of even date securing above notes.

The agreement provided that once Hobac's indebtedness to Union Planters National Bank had been liquidated, its stockholder-creditors had the right to declare any part of its indebtedness to them due and payable with the proviso that it might be deferred and paid in installments of $18,500 per year together with accrued interest. It further provided that the pledgee was authorized to receive payments on the notes, and was to hold the proceeds so collected as collateral security for the payment of the indebtedness secured. It was given the right to sue on the notes and to foreclose on the deed of trust securing such notes if necessary. The stockholder-creditors were given the right to look to the notes equally, and to demand that the

pledgee proceed, either by suit on the notes or under the deed of trust, to secure their payment. A supplement to that agreement was executed by Hobac's stockholder-creditors on January 30, 1953, wherein they acknowledged the equalization of the indebtednesses owed them by Hobac, and recited them to be in the following amounts:

O. D. Bratton	$ 41,595.40
Frank A. Conkling and Frank A. Conkling Company	41,595.40
James T. Ahern	41,595.40
Nola D. Holcomb	13,865.00
J. Ross Holcomb, Jr.	13,865.00
James A. Holcomb	13,865.00

By letter, dated December 30, 1952, Union Planters National Bank was authorized and directed to pay to any of the stockholder-creditors on request any sums held by it and due them as their pro-rata share of the proceeds of the Betz-Tipton notes held by it under the pledge agreement. Each of the notes has been paid as of its due date.

Hobac surrendered its corporate charter to the Secretary of State for the State of Tennessee on October 1, 1953.

On their 1952 return the Brattons reported as ordinary income the sum of $13,397.66, representing the amount received by them by virtue of the equalization agreement. They reported as capital gains the sum of $53,365.90, representing the excess of the value of their interest in the timberlands over the basis of their stock. All the amounts received by them during 1953, 1954, 1955 and 1956, under the so-called pledge agreement were reported as ordinary income.

On their 1952 return the Conklings reported as ordinary income the sum of $13,784.68, representing the amount received by them by virtue of the equalization agreement.

They reported as capital gains the sum of $53,365.90, representing the excess of the value of their interest in the timberlands over the basis of their Hobac stock. The amounts received by them during 1953, 1954, 1955 and 1956, under the so-called pledge agreement were reported as ordinary income.

The indebtednesses owed J. Ross Holcomb, Sr., were included in his gross estate as accounts receivable. His heirs reported all the income which they received under the so-called pledge agreement, as well as the excess of the value of their interest in the timberlands over the basis of their Hobac stock, as long-term capital gains. In the case of J. Ross Holcomb, Jr., James A. and Lou H. Holcomb and Nola D. Holcomb such excesses were $1.23, $1.24, and $1.23, respectively.

Respondent determined that in 1952, petitioners realized ordinary income upon the distribution of the timberlands to the extent that Hobac was indebted to each of them for commissions earned, and long-term capital gains to the extent that the balance of their respective interests in the timberlands exceeded the basis of their stock. Because the individual interests of the Holcomb heirs in the timberlands was less than the basis of their stock, he determined that the balance of their interests in those lands was not applicable against the basis of their stock until 1953, the year in which he determined Hobac made its final distribution in liquidation. He further determined that in 1953, petitioners received the total fair market value of the Betz-Tipton notes through distributions made by the trustee under the so-called pledge agreement; through collections made by the trustee which were available for distribution; and through receipt of the uncollected balance of those notes as a distribution in complete liquidation of Hobac. Accordingly, he determined that petitioners real-

ized long-term capital gains in 1953, to the extent that their individual interests in the Betz-Tipton notes exceeded the basis of their Hobac stock.

By amended answer respondent affirmatively alleged in the alternative that, should it be held that the liquidation of Hobac was completed in 1952, the amounts allegedly received in payment of the corporate debts were taxable to petitioners as ordinary income in 1952, and the balance of the assets allegedly received by them taxable as a long-term capital gain. By way of a second alternative, he further alleged that should it be held that the Betz-Tipton notes were received by petitioners in full satisfaction of the corporation's indebtedness to them, then that indebtedness was satisfied in full in 1953, and therefore petitioners were in receipt of ordinary income in that year to the extent of such indebtedness, and long-term capital gains to the extent that the face amount of the notes exceeded the amounts due them as commissions.

The Betz-Tipton notes in the face amount of $205,729.79 were secured by a deed of trust on the conveyed property and had a fair market value equal to their face amount as of the date of sale of the mill, equipment and inventories

OPINION.

The controversy revolves about the liquidation of a corporation, and the various transfers by it of its property pursuant to that liquidation. We are called upon to decide what the net effect of those transfers was, and their accompanying tax consequences to the petitioners.

Petitioners' position is that Betz and Tipton assumed Hobac's indebtednesses to them, and that they in turn released Hobac from any obligation thereon and agreed to look

solely to Betz and Tipton for its satisfaction. They therefore claim that, at the time they received the timberlands, Hobac was not indebted to them, and hence they are entitled to apply their respective interests in those lands against the basis of their Hobac stock. They further maintain that they were not required to take into income in 1953, the total face amount of the Betz-Tipton notes, but rather may report, in the year of their actual receipt, the amounts distributed to them by Union Planters under the so-called collateral pledge agreement.

At the outset we believe it pertinent to reiterate the familiar principle that substance rather than form governs the tax effect of transactions such as this. Acknowledging the right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by whatever means the law allows, the question still remains as to whether the transactions under scrutiny are in reality what they appear to be in form. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945); *Higgins* v. *Smith*, 308 U.S. 473 (1940); *Gregory* v. *Helvering*, 293 U.S. 465 (1935). Whether the various agreements executed by petitioners, Hobac, and Betz and Tipton were effective otherwise to reduce petitioners' taxes depends upon whether those agreements had any economic consequences, and not upon an inquiry into the motives of the petitioners. Simply stated, was the characterization given the instant series of events by petitioners in accord with substantial economic reality? *Haas* v. *Commissioner*, 248 F.2d 487 (C.A. 2, 1957); *Gilbert* v. *Commissioner*, 248 F.2d 399 (C.A. 2, 1957).

As we view them, the instant series of events effectuated a complete liquidation of Hobac as well as a satisfaction of its indebtedness to its stockholders in 1952. In December of that year Hobac was in the process of winding up its corporate affairs. Its officers and directors had been

authorized to complete its liquidation as quickly as possible by a sale of its existing assets and a satisfaction of all outstanding liabilities. The corporation was far from insolvent, possessing timberlands, inventories, a lumber mill and related properties. Other than a mortgage indebtedness of $47,681.40 owing Union Planters National Bank, and the indebtedness of $166,381.58 due its stockholder-creditors for salaries and commissions, the record reveals no claims of creditors. After taking stock of its financial position the corporation, through a series of related transactions, proceeded to liquidate. It sold its lumber inventory to an outsider for some $50,000. It disposed of its mill, log and veneer inventories and related properties to Betz and Tipton in return for their notes in the face amount of $205,729.79. It then distributed its two remaining assets, its timberlands and the Betz-Tipton notes, to its stockholders through two separate transactions. The timberland distribution was effected by an outright transfer of the property to its stockholders, who immediately disposed of them by sale to Anderson-Tully for $290,000. The distribution of the notes was effected through their pledge to Union Planters National Bank for the account of Hobac's stockholder-creditors, plus the purported assumption of the corporation's indebtedness by Betz and Tipton, thus satisfying Hobac's indebtedness to the stockholders. As we have noted above, the net effect of these various acts was the liquidation of Hobac and a satisfaction of its indebtedness during 1952.

But petitioners maintain that by virtue of Betz and Tipton's purported assumption of Hobac's liability to them, there was a shift of that indebtedness to Betz and Tipton, and therefore, at liquidation, they took Hobac's assets solely in liquidation of their stock. We do not agree.

Viewing the assumption of indebtedness agreement most favorably to the petitioners, it is apparent that Betz and Tipton did no more than agree to pay their notes, upon which they were already liable, to Hobac's stockholder-creditors. Thus, their liability arose by virtue of delivery of the notes, and not by virtue of their purported agreement to assume that indebtedness. The notes were negotiable and Betz and Tipton were obligated on them to any holder in due course to whom they might be negotiated by Hobac. In our judgment, that is the only conclusion which can be reached in the light of the assumption agreement, whereby the assumption was premised:

> upon the express condition * * * that all amounts realized from the collection of the deferred purchase money notes and demand note given by Betz and Tipton * * * and all amounts realized from any foreclosure and sale under the trust deed given * * * to secure said deferred purchase money notes and demand note be applied to the payment and satisfaction of the foregoing indebtednesses, * * *

We conclude that as a result of that agreement, Betz and Tipton did no more than agree to make payments upon the notes for the benefit of Hobac's stockholder-creditors.

However, petitioners maintain that as of the years in issue they had not received the notes, and that any interest which they might have had therein was limited by the collateral pledge agreement to a ratable share of the proceeds actually collected therefrom through payment or foreclosure, in any event not in excess of $18,500 per year. As we see it, this argument fails to take into account the real effect of the so-called pledge agreement.

After considering its provisions, more particularly those dealing with Union Planters' authority with respect to collections upon the notes, we have concluded that the

collateral pledge agreement in fact effectuated an assignment of the Betz-Tipton notes to Union Planters to serve as petitioners' agent for collection purposes, and that the stockholder-creditors thereby became the real owners of the notes in satisfaction of Hobac's indebtedness to them. This becomes all the more apparent when we consider that, despite the fact that the initial indebtedness purportedly secured was only some $166,000 and the face amount of the security some $205,000, no provisions were made for the subsequent return of the security to Hobac or its agent upon satisfaction of that indebtedness.

The Betz-Tipton notes were negotiable, interest bearing and secured by a deed of trust upon the properties for which they were issued; and they were given in full payment for those properties. Moreover, the parties have agreed that each note has been paid as it became due. Having been presented with no evidence to the contrary, we have concluded, and found as a fact, that as of December 20, 1952, the notes had a fair market value equal to their face amount. *Loyer* v. *Commissioner*, 199 F.2d 452 (C.A. 6, 1952), affirming a Memorandum Opinion of this Court dated April 30, 1951.

However, petitioners maintain that they received no vested property interest in those notes during the years in issue, and furthermore that they correctly reported the amounts received by them under the so-called pledge agreement in the year of actual receipt. We do not agree. Petitioners did not receive actual possession of the Betz-Tipton notes in 1952, solely because they chose to have them delivered to Union Planters for collection. The latter received them as petitioners' agent, and for their account. We are therefore of the opinion that petitioners were in constructive receipt of the notes in 1952. *Samuel E. Diescher*, 36 B.T.A. 732 (1937), affd. 110 F.2d 90 (C.A.

3, 1940), certiorari denied 310 U.S. 650 (1940). Inasmuch as we have found that the notes had a fair market value equal to their face amount, they were the equivalent of cash to petitioners upon receipt, and must be so accounted for. The provision made with Union Planters for their ultimate collection in no way affected their initial receipt. Rather it was merely the method chosen by petitioners to effectuate an orderly collection and distribution of the proceeds of each note as it matured.

We conclude that petitioners received both the timberlands and the Betz-Tipton notes from Hobac during 1952, by way of distributions in liquidation. To the extent of Hobac's indebtedness to each of them, the value of those assets represented ordinary income. Anything in excess thereof represented payment for their stock, and was taxable as a capital gain to the extent that it exceeded their basis therein. In computing Hobac's indebtedness to the individual petitioners the equalization agreement should be ignored. It was merely a private agreement between the stockholder-creditors as to the manner in which the proceeds from the sale of the timberlands would be divided, and neither increased nor decreased Hobac's liability to any of them.

No issue having been raised with respect to the addition to tax under section 294(d)(2) in Docket No. 60113 for 1952, it is hereby sustained subject to computation in the light of our disposition of the above issues.

Decisions will be entered under Rule 50.

APPENDIX B.

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

O. D. BRATTON and DOROTHY BRATTON, et al,
Petitioners,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Nos. 14062-14067
On Petitions for Review of the Decisions of the Tax Court of the United States.

(Filed October 31, 1960. Carl W. Reuss, Clerk.)

Before: MILLER, CECIL and WEICK, Circuit Judges.

PER CURIAM. The controversy here involves the tax consequences of distributions made to the shareholder-creditors of a closed corporation, upon its dissolution and liquidation. The shareholders were creditors in varying amounts for salaries and commissions owing to them by the corporation.

In the liquidation, the corporation undertook to distribute assets to its shareholders for their capital interests prior to the satisfaction of their claims as creditors. The corporation then handled the shareholders' claims as creditors by selling its mill and related equipment and certain inventories in exchange for long-term, instalment, negotiable, interest bearing promissory notes of the purchasers secured by a mortgage on the property sold by the corporation to them. The corporation transferred the notes and mortgage to a bank with authority to collect the payments on the notes and make distribution to the share-

holder-creditors. The purchasers assumed the indebtedness owing to the shareholder-creditors, but agreed to pay it only out of the instalments due on the notes. The shareholder-creditors released the corporation from said indebtedness and agreed to look to the notes secured by the mortgage.

The real dispute, between the parties, relates to the manner in which the notes should be treated for tax purposes. Taxpayers claim that the notes should not be considered as a distribution in cash and that they should be taxed only on the actual instalments paid on the notes as and when received by them from the bank. Taxpayers insist that the notes were never delivered to them and that they have neither title to or possession of the notes.

The Commissioner on the other hand maintains that the notes should be taxed at their full face value in 1952 at the time when they were transferred to the bank.

The Tax Court determined that the transfer of the notes to the bank was in reality for the benefit of the taxpayers and that the bank in collecting the instalment payments and distributing them to taxpayers was acting as their agent. The Tax Court further held that the notes should be taxed at their full face value at the time of the assignment to the bank since there was no proof that their fair value was any less, citing *Loyer* v. *Commissioner*, 199 F.2d 452 (C.A. 6, 1952). The Tax Court further held that the value of the notes represented ordinary income to the taxpayers to the extent of the corporate indebtedness owing to them, and that any sums received in excess thereof were taxable as capital gains to the extent that they exceeded the basis for their shares of stock.

We think there was substantial evidence to support the findings of fact and conclusions of the Tax Court. They

are binding on this Court unless clearly erroneous. *Commissioner of Internal Revenue* v. *Spermacet Whaling & Shipping Co.*, F.2d (C.A. 6, 1960).

The decisions of the Tax Court may be justified on another ground. Where the note of a third person is accepted by a creditor, it ordinarily operates as a payment and discharge of the indebtedness. *Southworth* v. *Thompson*, 57 Tenn. 10, 17 (1872); *Union Bank of Tennessee* v. *Smiser*, 33 Tenn. 501 (1853). Our case is stronger because the shareholder-creditors here actually released the corporation and agreed to look solely to the notes for the payment of their indebtedness. There was a substitution of a new debtor in the place of an old one and this constituted a novation. *Russell* v. *Centers*, 153 Ky. 473; *Crabb et al.* v. *Cole*, 19 Tenn. App. 201.

The decisions of the Tax Court are affirmed.

APPENDIX C.

Judgment.

October 31, 1960.

On Petition to Review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

Approved for entry:

/s/ Paul C. Weick,
United States Circuit Judge.

APPENDIX D.

Order Denying Rehearing.

December 6, 1960.

Upon consideration,

IT IS ORDERED that the Petition for Rehearing be denied.

Approved for entry:

/s/ Paul C. Weick,
United States Circuit Judge.

APPENDIX E.

No. 14,062

UNITED STATES COURT OF APPEALS
For the Sixth Circuit

O. D. Bratton et al.,

vs.

Commissioner of Internal Revenue

Mandate.

(Filed December 19, 1960.)

THE PRESIDENT OF THE UNITED STATES OF AMERICA.

To the Honorable Tax Court of the United States

—GREETING:

WHEREAS, lately in the Tax Court of the United States before you or some of you, in a cause between O. D. Bratton and Dorothy Bratton, J. Ross Holcomb, Jr., Frank A. Conkling and Eula W. Conkling, James A. Holcomb and Lou H. Holcomb, and Mrs. Nolah D. Holcomb, Petitioners, and Commissioner of Internal Revenue, Respondent (T.C. Nos. 60092, 60093, 60105, 60112, 60113), decisions were entered on the 20th day of May, 1959.

AND WHEREAS, the said O. D. Bratton, et al., Petitioners, petitioned this court as appears by inspection of the transcript of record of the said Tax Court of the United States which was brought into the United States Court of Appeals for the Sixth Circuit by virtue of a petition to

review agreeably in the Act of Congress, in such cases made and provided, fully and at large appears.

AND WHEREAS, in the present term of October, in the year of our Lord, one thousand nine hundred and sixty, the said cause came on to be heard before the said United States Court of Appeals for the Sixth Circuit, on the said transcript of record, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

YOU, THEREFORE, ARE HEREBY COMMANDED that such proceedings be had in said cause, in conformity with the opinion and judgment of this court, as according to right and justice, and the laws of the United States ought to be had, the said petition to review notwithstanding.

WITNESS, the Honorable EARL WARREN, Chief Justice of the United States, the sixteenth day of December, in the year of our Lord one thousand nine hundred and sixty.

/s/ Carl W. Reuss,
Clerk, United States Court of Appeals for the Sixth Circuit.

COSTS—NONE.

APPENDIX F

Internal Revenue Code of 1939.

Section 22. Sec. 1, Gross Income.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . .

APPENDIX G.

Treasury Regulation 118, promulgated under the Internal Revenue Code of 1939:

> Section 39.42-2. Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner or payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.

FILE COPY

FILED
JAMES R.

No. 775

In the Supreme Court of the United States

OCTOBER TERM, 1960

O. D. BRATTON, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

ARCHIBALD COX,
Solicitor General,
LOUIS F. OBERDORFER,
Assistant Attorney General,
A. F. PRESCOTT,
ARTHUR I. GOULD,
Attorneys,
Department of Justice, Washington 25, D.C.

In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 775

O. D. BRATTON, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The stock of the Hobac Veneer and Lumber Company ("Hobac") was owned equally by four stockholder-officers,[1] each of whom also had claims against the corporation, in varying amounts totalling some $166,000, for unpaid salaries and commissions. Hobac was also indebted to the Union Planters National Bank ("the Bank") in the amount of $47,681, secured by a mortgage on its properties. In 1952, the stockholders decided to liquidate the corporation, and on December 18–20, transactions the effect of which was as follows occurred:

[1] J. Ross Holcomb, Sr., O. D. Bratton, Frank A. Conkling, and James T. Ahern. Holcomb died in 1951 and his interest passed to his wife and sons (Nolah, J. Ross, Jr., and James A. Holcomb). For convenience, the Holcomb heirs will be referred to as a single one-fourth stockholder.

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(1) Hobac conveyed its timberlands to the stockholders, and the stockholders sold them to a third party for $290,000 in cash. $47,681 of the proceeds was paid to the Bank in satisfaction of Hobac's indebtedness to it and in discharge of the mortgage. The balance of the proceeds was distributed among the four stockholders in unequal amounts, the differences in which were equal to the differences in their respective compensation claims against Hobac.

(2) Hobac sold its mill and related properties to E. L. Betz and Joseph Tipton in exchange for negotiable, interest-bearing notes, payable in part on demand and in part in installments, in the face amount of $205,000. The notes were secured by a deed of trust on the properties sold.

(3) Hobac transferred the Betz-Tipton notes to the Bank pursuant to an agreement, joined by the stockholders, whereby the Bank would collect the proceeds of the notes and pay them over to the stockholders. In exchange, the stockholders released Hobac of any further liability on their compensation claims.

Hobac completed its liquidation in 1953 and surrendered its corporate charter.

The Tax Court, in deficiency proceedings involving three[1] of the four stockholders, held that the stockholders had received in 1952, as a distribution from Hobac, not only the timberlands but also the Betz-Tipton notes. It further held that the part of the amounts realized equal to the stockholders' salary and commission claims constituted compensation (taxable

[1] Bratton, Conkling, and the Holcomb heirs. The wives of stockholders who filed joint returns are also parties.

as ordinary income) and the balance constituted a capital distribution in liquidation (taxable as capital gain to the extent it exceeded the taxpayers' basis for their stock). The court of appeals affirmed.

The taxpayers claim that the Betz-Tipton notes were not "received" by them in 1952 and that they had taxable receipts on account of the notes only in the subsequent years when the proceeds of the notes were paid over to them by the Bank. Both courts below found that the notes were negotiable and had a fair market value equal to their face amount, and those findings present no question appropriate for review here. Accepting those findings, we think it is plain that the notes were "property" which, had they been distributed directly to the stockholders, would have been taxable to the stockholders at their fair market value in the year of receipt. It is equally plain that the stockholders could not defer their "receipt" of the notes by the mere device of having their controlled corporation transfer the notes to their nominee (the Bank) to act as a collection agent on their behalf. The interposition of the Bank would be effective to defer the taxpayers' receipt of the notes only if the Bank's role was something other than that of a collection agent.

In structuring the transaction, taxpayers sought to give substance to the transfer of the notes to the Bank in two ways. First, it was attempted to give the stockholders only a security interest rather than a beneficial interest in the notes. That was done by having Betz and Tipton purport to "assume" Hobae's indebtedness to the stockholders (*i.e.*, their compen-

sation claims), with Hobac then "pledging" the notes with the Bank to "secure" Betz and Tipton's payment of those claims. In fact, however, Betz and Tipton "assumed" no obligation other than their obligation to pay the notes given as the purchase price of the property, for the agreement went on to say that the payments on the notes were to be applied in discharge of the stockholders' compensation claims—*i.e.*, a single payment was to discharge both the notes and the "assumed" indebtedness to the stockholders. There being no obligation on the part of Betz and Tipton other than to pay the notes as they became due, there was no other obligation for the notes to "secure." What the stockholders got from the transaction was neither more nor less than the right to the proceeds of the notes themselves, a right, moreover, which was not limited to the amount of their compensation claims but extended to the entire proceeds of the notes. In short, the purported "assumption" of indebtedness by Betz and Tipton and the "pledging" of the notes was a meaningless pretense affecting the substance of the transaction not at all.

The second attempt to give color to the "pledge" of the notes to the Bank was by providing that none of the proceeds of the notes was to be paid to the stockholders until the indebtedness due the Bank by Hobac ($47,681) had first been paid. It is upon that aspect of the agreement that taxpayers primarily rely here, asserting that the reason "why such notes were required to be held in escrow and why petitioners were not able to exercise control or ownership over" them was that the proceeds "were not to be applied

toward payment of petitioners' claims as creditors until such time as the Bank had been paid in full" (Pet. 15). The answer is that the Bank *was* paid in full, from the proceeds of the sale of the timberlands, on the very day (December 20, 1952) that the notes were transferred to the Bank, so that in fact neither the Bank nor anyone else had any interest in the notes other than the stockholders.

In summary, the net effect of the transactions of December 18–20, 1952, though clothed in a veil of purported "pledges" and "assumptions" of indebtedness, was to divest Hobac of its interest in the notes and to give to the stockholders the entire beneficial interest. Having full control of the corporation, the stockholders could as well have distributed the notes directly to themselves, and the formal transfer of the notes instead to the Bank served no function and had no substance other than to make the Bank a collection agent for the stockholders. Hence the courts below correctly concluded that the notes were constructively received by the stockholders in 1952. There is no con-

[3] Had taxpayers been successful in deferring their receipt of the notes, there would then have been an additional question as to the nature of the receipts in the several years—namely, which receipts constituted a capital distribution and which the payment of their compensation claims. As the transactions were structured by the taxpayers, the order of the steps was: (1) Betz and Tipton "assumed" Hobac's indebtedness for the compensation claims, the notes were transferred to the Bank to "secure" payment of that indebtedness, and the stockholders "released" Hobac from any further liability on those claims; and (2) Hobac then distributed the timberlands to the stockholders. By that sequence, taxpayers hoped to qualify their immediate receipts (the timberlands) as the capital distribution and their deferred receipts (the proceeds of the notes) as the payment of their compensation. While the failure of the at-

flict ' or other reason for review by this Court. The petition for certiorari should be denied.

Respectfully submitted.

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tempted deferral of the receipt of the notes pretermits that question—with the timberlands and the notes being received in the same year, it makes no difference which constitutes a capital distribution and which ordinary income—the attempt to give to the several receipts the most beneficial tax characterization helps further to explain the contrived nature of the transactions.

' *McLaughlin* v. *Commissioner*, 113 F. 2d 611 (C.A. 7), is distinguishable. In that case, a sale of stock was effectuated by an agreement under which both the stock and purchase-money notes were deposited in escrow. As each note was paid, an allocable portion of the stock was to be released to the buyer, and the note proceeds were to be paid over to the seller. In the event of default on the notes, the escrowee was directed to sell the stock and to bid an amount equal to the face amount of the unpaid notes. The effect of the default provisions, as the court observed, was that the buyer was entitled to have the stock applied in full discharge of the notes, and the seller's rights were limited to receiving back the stock itself. Primarily because of that reserved right of the buyer to have the notes discharged by a return of the stock, the court concluded that the escrowee held the notes as a representative of the buyer and hence that the seller did not constructively receive them. There is no parallel here, where the notes were an unconditional obligation of a third party (Betz and Tipton); the transferor (Hobae) irrevocably divested itself of, and the transferees (the stockholders) acquired, the entire beneficial interest in the notes; and the escrowee had no function or powers other than to collect and pay over the proceeds of the notes.

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